No. 9812

In the United States

Circuit Court of Appeals

For the Ninth Circuit

L. B. HIRSCH and MAX S. and
CLEMENTINE HIRSCH,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

Reply Brief of Petitioners-Appellants

Upon Petition to Review Decisions of the United States Board of Tax Appeals

FILED

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REPLY BRIEF OF PETITIONERS-APPELLANTS

The respondent in his brief has cited a large number of decisions in support of his contentions on the issues involved in the instant case. We deem it unnecessary to analyze and to distinguish each of these citations since the respondent agrees with the petitioners that each case coming under 115(g) must be decided on its own facts and be determined upon the circumstances surrounding each case. We call the court's attention again to the generally accepted rule as to the interpretation or Section 115(g) which is found in *McGuire v. The Commissioner* (C.C.A. 7), 84 Fed. (2d) 431, wherein it is stated: "It is of course

not every cancellation or redemption of corporate stock that is taxable, but only if made at such time and in such manner as to be essentially equivalent to a distribution of a taxable dividend. The time and manner are distinct elements pointing to the conclusions of the Board."

We deem it necessary, however, to reply to some of the contentions made by the respondent to each of the issues presented in his brief:

Issue I.

The respondent in his brief contends that irrespective of motive, business purpose, profits available for distribution, or any other fact showing the true character of the transaction, as applied to the instant case, required a holding under Section 115(g) of the Revenue Act of 1934 that the corporation's redemption of a number of shares of stock of the petitioners in cancellation of their respective debts to the corporation "to be essentially equivalent to a distribution of a taxable dividend." We submit that such is not the law and a holding which ignores the uncontradicted evidence surrounding the transaction involved in this case is erroneous and cannot be supported. It is, of course, conceded that if the finding of the Board of Tax Appeals is supported by substantial testimony, such finding must be upheld, but we submit that the

respondent has failed to answer the contention made in the primary brief that the finding in this case is wholly unsupported by any probative evidence.

We respectfully call the court's attention to the fact that the testimony of Eric P. Van, the petitioners, L. B. and Max S. Hirsch, and of H. A. Weis, stating the purposes and the circumstances surrounding the cancellation of the indebtedness of the petitioners and of the surrender of the stock in question was not disputed, and must be taken as the admitted evidence in the case. The respondent wholly ignores this evidence but suggests that the same purpose might have been accomplished by a declaration of a dividend. We wish to point out that the testimony indicates that such a purpose could not have been accomplished without creating considerable disadvantage to the corporation. First, as we pointed out in our main brief, the corporation did not have sufficient cash to declare a dividend of 10% or 14% which was required to accomplish the purpose. Second, the condition of the corporation was such that a declaration of a dividend at that time would have been, as testified to by Mr. Van, "poor business judgment." We respectfully submit that if in every instance where a corporation redeems a portion of stock held by one of its stockholders for the purpose of cancellation of a debt is to be deemed a declaration of a dividend, then there could be no instance where a

stockholder unable to pay his debt to the corporation could by agreement or otherwise cancel his debt by the surrender of his stock or any portion thereof. Such a construction of Section 115(g) is clearly beyond any holding of any court at any time.

We respectfully call the court's attention further to the fact that the respondent has made no answer to the case of *Allen v. The Commissioner*, 41 B.T.A. 206, which, in our judgment, is squarely on all fours with the facts in the instant case. In the Allen case we have precisely the same purpose, the same method and the same result, and, in that case the Board held, as it should have held in the instant case, that the transaction was not "equivalent to a declaration of a dividend."

At Page 5 of his brief respondent states that the directors decided on December 21, 1935 that Hirsch brothers should pay off their indebtedness to the corportation by turning in 10% of their stock and that the other stockholders were to have the same privilege. This is not a true statement of the evidence. The uncontradicted evidence is that at the informal meeting of the Board of Directors on December 21, 1935, all that was discussed and all that was agreed upon was that the corporation would redeem a sufficient number of shares of stock of the petitioners for the purpose of cancelling their indebtedness to the cor-

poration. No privilege to any one other than these two stockholders was discussed. No mention was made of any dividend to be declared. In fact it is admitted by the respondent that the minute was adopted almost two years after December 21, 1935. (Respondent's Brief, Page 6.) It is true that while the minute on its face seems to extend the privilege to stockholders to take advantage of the situation and to turn in a number of shares of stock, it must be borne in mind and the evidence is uncontradicted that the real purpose of the drafting of this minute was, as was testified to by the petitioners and Weis, to assure Mr. Weis that if in the future he would be unable to repay any indebtedness that might be then due and owing from him, that he would be given the opportunity to turn in a sufficient number of shares in cancellation of such indebtedness. No contradictory evidence was given by the respondent to deny that that was the purpose, the intention and the fact of the situation.

Furthermore, it is significant that during all of the time since December 21, 1935 to the date of trial Mr. Weis did not take advantage of that privilege and neither did any of the other stockholders with the exception that long before December, 1935, a small number of shares were redeemed by the corporation from some of the smaller stockholders because of the seeming want of these stockholders. Similarly, a few

shares of stock were turned in by one or two of the stockholders in the year 1936 so that they could obtain their money because of need. There is no evidence of any kind to show that the privilege which the respondent contends was given to all of the stockholders had ever been, in fact, given to them or contemplated. The uncontradicted testimony with reference to the minutes adopted in 1937 is that it was to secure Mr. Weis should he become a debtor of the corporation at any time in the future.

Respondent tries to emphasize the fact of the by-laws of the corporation required that an annual dividend be declared and points out that the original requirement was mandatory and that subsequently the wording was changed so as to make it merely permissive. It is difficult to understand the contention made regarding this. Is it to be taken that the corporation would be required to declare a dividend even though there were no profits from which to pay same? It is of course obvious that whatever the by-laws may provide a Board of Directors of a corporation can only declare a dividend when profits are available from the operation of the business.

We again respectfully urge that there is no distinction between the instant case and the case of *Allen v. The Commissioner, Supra*, and we repeat what was said in that case, namely:

"We think such showing has been made. Numerous cases have laid down the rule that the statute must be interpreted in the light of the facts in each situation. Decisions are varied, some finding and others denying equivalence to distribution of a taxable dividend. They need not be enumerated. The crux of the matter here is that stockholders were indebted to the corporation, that the corporation's business was such that it required large amounts of money on short term notes and had for several years been in the habit of borrowing, through brokers, such money at extremely low rates of interest, that in order to secure such low interest rates it was necessary to maintain a high credit standard, and that the brokers objected to loans to the stockholders or officers of the corporation. They vigorously urged the elimination of such loans even to the extent of suggesting a cessation of borrowing after one bank, which had been in the habit of lending to the corporation through the brokers, had declined to do so because of the indebtedness of the stockholders.

* * * * *

"We said that such reasons could not be disregarded and that neither the time nor the manner of the redemption indicated an ordinary dividend."

We therefore respectfully submit that as to Issue I the finding of the Board of Tax Appeals is without any substantial evidence to support it and is erroneous and should be reversed.

Issue II.

The respondent contends that the Board's finding that a debt owed to petitioner Max S. Hirsch by Leo W. Seller did not become worthless in 1935, but it became so in 1934, and hence was not deductible in the petitioner's income tax return of 1935 and bases his argument on the contention that no reasonable man would have expected further recovery after 1934. We respectfully urge that the record with respect to this issue would lead to no other conclusion than that the petitioner, Max S. Hirsch, used every reasonable means of determining when his loss actually occurred, and it was fixed in 1935, and at no other time. A full discussion of the contention of the petitioners on this issue was set forth in the primary brief, but we desire to summarize the undisputed facts with reference to that situation, namely: the loan was made by the petitioner to the debtor, Leo W. Seller, to enable him to establish a business in Seattle, Washington. Second, the business became insolvent and thereby necessitating not only the liquidation of the assets of the business, but also the ascertainment of whether the debtor, Leo W. Seller, had any other means to repay the balance due said Hirsch. Third, the undisputed fact is that Seller did have reasonable prospects of repaying the balance until he suffered a stroke in 1935 and became disabled to such an extent as to nullify any reasonable likelihood

of repayment. It is our contention that this was the identifiable event which determined that there would be no further payments. It does not seem to us to be the policy of the law to penalize taxpayer for exercising some degree of judgment and patience as to a debt which the creditor expects may still be repaid. The respondent suggests that because Seller was married to Hirsch's sister (the respondent is in error as to this statement since Seller was the brother of the petitioner's wife) that his testimony is to be viewed with caution. We feel on the contrary, that the very fact of the relationship between Seller and the petitioner, Max S. Hirsch, would lead to a little more patience and a more careful consideration of whether the debt was likely to be repaid or not. Rather than to take summary judgment in 1934, the petitioner in good faith believed that as long as Seller was in good health, that there would be a reasonable possibility of repaying the balance when his earnings reached a point which would have permitted him to do so. Only when Seller suffered a disabling stroke did the petitioner determine that the loss was then fixed and certain. We respectfully submit that the facts in this case are governed by the decision in *Dunbar v. Commissioner,* 119 Fed. (2d) 367 wherein it is stated: "The taxing act is to be construed most strongly against the government.

As the Supreme Court, said in *U. S. v. White Dental Co.*, 274 U.S. 398," the taxing act does not require the taxpayer to be an 'incorrigible pessimist', neither does it require him to be an 'incorrigible optimist'." We earnestly contend that upon all of the facts the only finding that is sustainable is that the petitioner acted in good faith and with reasonable judgment and that the loss was fixed in 1935 and should be allowed as deductible in the return of the petitioner for that year, and the finding of the Board on that issue is, we respectfully submit, in the light of the evidence, erroneous and should be reversed.

Issue III.

On this issue the respondent endeavors to show that the Lows were not dependent upon petitioner, L. B. Hirsch, for support, on the grounds that the dependents had independent means; that the taxpayer owed his sister $9,000.00 and that the taxpayer owed the corporation $20,000.00, of which the Lows owned 45%; the respondent drawing the conclusion that the petitioner was indebted to the Low family for more than $19,000.00. The record is uncontradicted that L. B. Hirsch contributed for many years from $350.00 to $400.00 per month for the support of the family. (Tr. 151) Had he applied these advances for the maintenance of the Lows against the indebtedness, it would have been entirely absorbed in three or four years.

Furthermore, as the record discloses, the moneys withdrawn from the corporation were withdrawn for the support of the family, although charged directly to L. B. Hirsch. (Tr. 162)

As to the independent means of support, reference is made to Page 12 of respondent's brief showing that the Lows' earnings were approximately $400.00 or $500.00 per year. On Page 13 of the brief reference is made to the earnings of the Hirsch Investment Company, in which the Lows owned 45% of the stock. The earnings in 1935 were $869.78, and 45% of this amount would be $391.40. The earnings in 1936 were $979.52, and 45% of this amount is $400.78. Despite all of this, the respondent admits, Page 12 of his brief, that the taxpayer contributed $350.00 to $400.00 *per month* to the maintenance of the household and in addition paid medical bills and contributed to the education expense of Barbara. It is submitted that the conditions existing in so far as the petitioner, L. B. Hirsch, is concerned, met all the requirements laid down by the Regulation as to the personal exemption of head of a family and as to credit for dependents.

The respondent in his brief suggests that the recommendation of the Internal Revenue Agent as set forth on Page 44 of the primary brief (Respondent's Exhibit J) is not binding upon the Commissioner. It is, of course, conceded that such recommendation has no

finality but we again submit that it is significant that upon a thorough investigation by the Internal Revenue Agent, who was conversant with all of the facts and circumstances surrounding the relationship between the petitioner and the Low family, that the recommendation was made that the petitioner be allowed an exemption as a head of a household.

CONCLUSION

In conclusion we respectfully submit that the record in this case clearly demonstrates that the uncontradicted and overwhelming testimony under the authorities would lead to no other conclusion but that the findings of the Board of Tax Appeals on the three issues involved were contrary to the law and should be reversed.

Respectfully submitted,

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